SEEING VALUE IN EVALUATIONS
30TH NOVEMBER, 2017 | MUMBAI

SUMMARY OF DISCUSSIONS

RATIONALE

Schedule IV of the Companies Act, 2013 provides for the review of the performance of the Non Independent Directors and the Board as a whole, the review of performance of the Chairperson, and the performance evaluation of Independent Directors. This wholesome provision, instead of being utilized as an instrument for assessing whether the Board and individual Directors are measuring up to statutory expectations, is being treated by a large number of companies as a mechanical and consequently, meaningless exercise. Such companies and their Boards and Managements treat the process of evaluation as one more box to be ticked.

Even though as the Act and SEBI Regulations clearly stipulate that individual Directors are also to be evaluated, many companies shy away from this aspect of the evaluation process, on the ground that it could cause damage to a cohesive and collegial Board.

Since the process of evaluation is with reference to a financial year, any meaningful evaluation process for the current financial year should commence without any further loss of time.

DISCUSSIONS

"I did not apply for a job, I was invited. So why should I be evaluated?"

Of the Nifty 50 companies, 42 companies undertook Board evaluation exercise.
Process of evaluation -

- *Evaluation done completely in-house – 33*
- *Evaluation done by external consultants – 02*
- *Evaluation done by a mix of in-house team and external consultants – 07*
- *Oral assessments, peer evaluation, questionnaires, and rating sheets were the common modes.*
- *Some companies mentioned some of the parameters on which the Directors were assessed.*

Disclosures by companies

- *21 gave details of the meeting (including 02 which gave the date) in which evaluation was conducted.*
- *27 companies specifically mentioned a role for NRC in the process.*
- *Law requires companies to evaluate the Board, its committees, Chairperson and Directors. Some companies have not evaluated all the four.*
- *Feedback, post the process, is almost non-existent.*

Some unanswered questions

- *Does the NRC vet the portion on Board evaluation in the annual report?*
- *Have companies changed the process/ basis/ questionnaire for Board evaluation since 2014, when it was first carried out?*
- *Have companies moved to treating this as a complete year exercise, and not a quarter 4 exercise?*
- *Has the outcome from the previous evaluations resulted in any feedback/ action plan?*

Board evaluation, if done properly, should be a meaningful exercise. Dishonest evaluation is worse than no evaluation. Teething troubles relating to Board evaluation are over with most companies having decided the process for evaluation. There has been an increase in the number of companies undertaking Board evaluation either to meet the legal prescriptions or because they have started seeing some value in evaluation.

- The objective of a proper evaluation exercise should be to demonstrate to all stakeholders that a proper exercise was undertaken and that the Directors, especially Independent Directors, were not sleeping on the job.

- Board composition in most Indian boards is nowhere near perfect. Further, boards lack role clarity. In this background, evaluations if undertaken has become a mere ritual.
- **Attitude of Board and Management's to Board evaluation -**
    - Ownership of the company does not seem to influence Board evaluation exercise. Both promoter companies and management run companies have shown different degrees of commitment to the process. It ultimately depends on the relevant individuals in the companies.
    - While Boards and managements do believe in Board evaluation, the process depends on their individual attitude towards it.
    - Some promoters feel that having invited each Director to their Board, they know each Director well enough to not require an evaluation for them. For such promoters, a drastic change in mindset is required.
- **Chairperson of Board -**
    - A lot depends on the Chairperson of the Board since she drives the process and sets the tone for freedom of expression at the top.
    - Her biggest role is to facilitate an ongoing informal conversation, which can result in a constructive evaluation process by building trust within the Board. This however does not usually happen. If done correctly, there is no need for an external evaluator.
    - While some Chairpersons are proactively pushing for a meaningful exercise, many of them are resisting an evaluation exercise since they are concerned about a possible negative outcome.
- **Chairperson of NRC -**
    - Chairperson of NRC has a major role in finalising the process for evaluation, and then conducting it.
    - Continuing conversation within the Board is an area where she can and must play an active role.
- **Commitment of Directors -**
    - For the process of evaluation to be effective, Directors too should be committed to the success of the process, despite their busy schedules.
    - A number of Directors are unsure of what, if anything an annual evaluation of the same Board seeks to achieve. They also feel that evaluation on the basis of only 4 annual meetings is unrealistic.
    - Added to that, a number of Directors are not honest in the process. This makes the process redundant, and sometime counter productive.
    - Most of the Directors are currently passively resisting it since they are concerned about the outcomes. As a result, they are encouraging only a rudimentary process for evaluation.
    - There is a huge resistance for an external evaluation, and for evaluation of individual directors.
    - This is so, since the maturity to deal with the outcome is often missing, and most directors are insecure about the process.
    - However, despite the resistance, evaluation has not resulted in any Director having to leave the Board.
- **Separate meeting of Independent Directors -**
    - Law provides for at least one annual separate meeting of IDs in which evaluation has to be undertaken. Sadly, this has been interpreted by most companies as one end of the year annual meeting in which evaluation has to be undertaken.
    - As a result, at present, instead of it being a continuous activity, most companies undertake Board evaluation in the last quarter of the financial year since it has to be reported in the Annual report of the company.
    - Instead of it being a single meeting, at the end of the year, there should be at least a quarterly meeting, so that in addition to developing a culture of an ongoing conversation, mid-course corrections, if any, for the improvement of the Board can be attempted.
    - In this meeting the entire working of the Board and its processes, including the role of Chairperson, should be discussed honestly by directors, and presented to the entire Board, after taking the Chairperson into confidence.

- **Process of evaluation -**
    - Some companies forget that it is not a mechanical process, and involve sensitivities ,which must be respected.
    - Ideally, the process should have a quantitative as well as a qualitative aspect attached to it.
    - Questionnaire approach can address the quantitative responses, and interviews with Directors can take care of the qualitative aspect of evaluation. For the process to be meaningful and successful, both these should work in tandem.
    - Questionnaire approach, which is being followed by most companies, has resulted in tick the box approach to the entire process, since most Directors are unsure about the custodian of these responses, and hence give politically correct responses to the questions.
    - Companies that have one-to-one discussions on the basis of these questionnaires find that the responses of Directors often differ From the written responses and directors say much more in these discussions.
    - Further, most companies focus on evaluating only the Board as a whole. Committees are evaluated only by the members of the committees. Individual directors' evaluation being the most sensitive of them all, is not always undertaken. With most Board members not being privy to discussions in the committee meetings, it is thought that it is ideal for the committee to be evaluated only by its members. However, if Boards set their expectations from committees, and in addition, Chairpersons of committees brief the board post their meeting, the entire board can have a greater role in evaluating committees as a whole.
    - In a few companies, focus of evaluation is changed each year, to cover the Board and its committees in greater depth.
- **Factors to be considered in evaluation (but are not always considered) -**
    - Conflict of Interest – It is a mindset. Disclosures by Directors are reactive.
    - Board engagement – Board engagement is an input. Evaluation is only an output which derives from it.
    - Culture – Often ignored in the evaluation process, it impacts the quality of interactions and discussions, and behaviour in boardroom, as also boardroom dynamics. Unlike Indian boards, foreign Boards spend time both pre-meetings and post-meetings on culture and its impact on boardroom dynamics.
    - Strategy – Boards have a big role in finalising strategy. Most Boards do not understand this. Instead, they tend to micro-manage.
    - Time commitment – For Board evaluation to be successful, conversation between different board members, both in board meetings and between board meetings, is vital. Time and mental bandwidth of directors will go a long way in making this process meaningful.
    - Right attitude and domain knowledge are also important, but often not considered.
- **External Evaluations –**
    - Effectiveness of an external evaluation primarily depends on the evaluator.
    - If an external evaluator is engaged, some of the factors that the Board must consider are the firm, and its experience in Board evaluation; the team dealing with evaluation; the process followed; and the kind of questions that they might be prepared to ask.
    - The evaluator's understanding of the sensitivity of the subject, of boardroom dynamics and her own practical boardroom experience is vital to the process, but often ignored.
    - Objectivity of the evaluator is yet another key area that is often ignored. She is a service provider, and at times, in the interest of a long term relationship with the company, she may not ask the tough questions or be honest about the feedback received.
    - One advantage with having an external evaluator is that individual directors can be evaluated. Senior management's views on the board's functioning too can be gathered in the process. This might be difficult if evaluation is done in-house.
    - Continuity of an evaluator is important too. The practice of changing an external evaluator , where used, each year is not right since there should be some continuity in the process.

Companies should consider having the same evaluator for at least 3 years to measure any real changes coming from the evaluation process.
  - In the United Kingdom, the annual process of evaluation is rigorous. Further, it is compulsory to have an external evaluator conduct this exercise once every 3 years. The entire process has to be disclosed in the annual report. However, 21% of the companies in UK voluntarily undertake an exercise with an external evaluator since they find that it adds value.
  - In India, there are not enough Indian firms who deal with evaluation.
- **Possible Outcomes of Evaluation -**
  - Feedback -
    - Feedback is rarely given to directors post the evaluation.
    - Further, the current generation of directors is averse to evaluation, and resultant feedback, since most of them have not been evaluated in their working life.
    - Feedback loop has been added by a very few companies. While some directors would want feedback, they would want it in a non-threatening manner. The method of providing feedback is very important. Equally important is the process of feedback which should be continuous, and not episodic.
    - In case an external evaluator is engaged, individual feedback, if given constructively, can enrich the process.
    - Chairperson of Board and Chairperson of NRC have a major role in giving feedback to individual directors. All the Independent directors, or a lead Independent Director, or Chairperson of NRC can provide feedback to the Chairperson of the Board.
    - One alternative to one-to-one feedback conversation that some persons consider could be mails being sent to individual directors by the Chairperson so that difficult conversations can be avoided. This is at best a suboptimal solution.
  - Conversation - If both the Chairperson and the members of the Board take out time for the crucial conversation post the evaluation process, it can add a lot of value to the exercise.
  - Action plan – Board evaluation is not an end in itself. It should lead to an outcome and an action plan for the Board.
  - Disclosure in Annual Report – Boards should set targets for themselves disclose them in the annual report for transparency, and work towards them.
  - Remuneration -
    - Evaluation should result in a differential remuneration paid to directors. However, most companies in India continue to consider attendance and committee memberships and chairpersonships as the primary parameters for deciding remuneration for directors.
    - Some Directors feel that difference in remuneration might be considered to be akin to penalising some directors for non-performance. As a result, evaluation should only result in sharing of feedback, with no effect on remuneration.
    - Some directors also feel that Board members do not get motivated based on increased remuneration and so this should not be an outcome post the evaluation process.
    - Chairperson of NRC will have a role to play in this.
  - Both the Board composition and Board processes are improving in some companies as a result of evaluation.
  - Improvement of Directors – Improvement of the performance of Directors, and not their exit, should be the objective of the exercise. Also, most companies have appointed their Directors for 5 years, and so are unlikely to go to the shareholders to remove a director based on the findings in the evaluation process. Persuading a non performing Director to exit the Board is also seen as a difficult exercise.
- **Stakeholders** – At present, the pressure from stakeholders for conducting a meaningful evaluation exercise is not present.
  - Proxy Advisory firms – If they exert pressure, companies will definitely improve the process.
  - Shareholders – As in the United Kingdom, shareholders should also see this as a mechanism through which they can hold the directors accountable. If in 2019, they use this as a tool to

evaluate the performance of directors who have been on the board, it would be a fruitful exercise.

- **How will companies follow it willingly? -**
    - If Board evaluation results in giving the company a competitive advantage, companies will voluntarily undertake it. The competitive advantage can be in the form of premium in the market, good investors, better lending terms, good talent etc.
    - If India has Corporate Governance rankings, and evaluation could be factored into those rankings, companies would willingly undertake evaluation.
- **Future of evaluation -**
    - The suggestion that evaluation of individual directors can wait for phase 2 since it is being resisted by a majority of directors is unacceptable since there is a statutory requirement to do so.
    - Evaluation could be conducted before a Director joins the Board to check whether or not she is appropriate for the Board.
    - In 2019, there would be a number of changes in Board composition. The directors who would be appointed would be aware that an annual evaluation exercise would be conducted, unlike the directors presently on boards. It is to be hoped that , would make the process more meaningful, with a greater buy-in from directors.
    - The recommendation of the Kotak Committee, on Corporate Governance could result in more English written on Board evaluation in annual reports, rather than leading to meaningful process improvements.

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